



GREEN
CLIMATE
FUND

Brief Guideline on the Application of the Case-by-case Provisions in the Financial Terms and Conditions of the Fund's Instruments

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Brief Guideline on the Application of the Case-by-case Provisions in the Financial Terms and Conditions of the Fund's Instruments

I. Introduction

1. At its fifth meeting, the Board of the Green Climate Fund adopted a set of guiding principles and factors for determining terms of financial instruments, as outlined in decision B.05/07.¹ These guiding principles and factors constitute the foundation of the terms and conditions of the Fund's instruments.
2. At its ninth meeting, the Board adopted the financial terms and conditions of the Fund's instruments (decision B.09/04).
3. Grants to the public sector are without repayment contingency. Concessional loans to the public sector will have high or low concessionality (decision B.09/04).²
4. The Board decided that use of grants with repayment contingency shall be limited to the private sector and that their terms and conditions shall be determined on a case-by-case basis.
5. The Board further decided that the financial terms and conditions for non-grant instruments to the public sector, other than concessional loans, will be established on a case-by-case basis.
6. The Board decided that all non-grant instruments extended to the private sector shall be determined on a case-by-case basis, taking into consideration decision B.05/07³ and to decision B.07/06.⁴
7. The Board requested the Secretariat to prepare and submit for the Board's consideration at its tenth meeting a brief guideline on the application of the case-by-case provisions in the financial terms and conditions of the Fund's instruments (decision B.09/04).
8. The purpose of this document is to present the brief guideline as requested by the Board.

II. Establishing financial terms

9. In order to consider how the Fund should apply terms and conditions on a case-by-case basis, we need to review the manner in which other institutions determine financial terms. As many public institutions decide terms of their instruments on a case-by-case basis, the Fund can learn from the practices of these institutions when deciding the terms of its financial instruments. A sample of the practices of other institutions is presented below in Table 1.
10. In summary, the general practice is to decide on a case-by-case basis using market sources of information and market data. These institutions provide their own financing at commercial terms, although they can also channel concessional financing from climate funds. The practices of climate funds in providing concessionality is outlined in section 3.1.2.

¹ Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013*.

² Annex II of the document GCF/B.09/23 *Decisions of the Board – Ninth Meeting of the Board, 24-26 March 2014*.

³ Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013*.

⁴ Chapter III in Annex XIV of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013*.

Table 1: Practices of other funding institutions⁵

Institution	Equity	Debt	Guarantees	Method for pricing
African Development Bank^a	The African Development Bank (AfDB) expects a rate of return reflecting an appropriate premium compared with a rate at which it would make a senior loan to the same company.	Interest rate terms = base rate (floating or fixed) ^b + lending spread (where lending spread is specific to project's risk).	A guarantee fee is charged that is similar to the credit spread on an AfDB loan (equal to the credit spread that would have been charged if the AfDB makes a direct loan, plus a risk premium).	The main responsibility for pricing non-sovereign loans is shared between the AfDB's Credit Risk Department, which provides the necessary margin to cover the risk that the Bank takes when undertaking a new operation, and the originating departments (Private Sector Operations Department and Financial Sector Development Department), which provide the final price after consideration of the flexible margin.
Asian Development Bank^c	Minimum hurdle rates are used.	In pricing its loans, the Asian Development Bank (ADB) considers prevailing market rates in the relevant country and sector, factoring in country and transaction risks. Interest terms = base rate (floating or fixed) + the lending spread (where lending spread is determined on a case-by-case basis so as to cover ADB's risk exposure to specific borrowers and projects).	No information.	In addition to market comparators, ADB's pricing is determined by a comprehensive risk rating system, which was developed with Standard & Poor's. The rating for each transaction is determined in cooperation between the Private Sector Operations Department and the Office of Risk Management after extensive due diligence. ADB's investment committee decides on the final pricing based on the risk rating submitted as well as market comparators.

⁵ This data was sourced through public sources on entities' websites as well as conversations with entities.

Institution	Equity	Debt	Guarantees	Method for pricing
European Bank for Reconstruction and Development^d	No information.	Full lending terms are negotiated with the client Loans from the European Bank for Reconstruction and Development are based on current market rates and are priced competitively. Interest rate = base rate (floating or fixed) + margin (where the margin is a combination of country risk and project-specific risk). EBRD charge a front-end fee in most cases of debt finance.	Maximum exposure must be known and measurable and the credit risk must be acceptable. Precise legal definitions of the events guaranteed and pricing are handled on a case-by-case basis.	Pricing is determined by using an internal risk model.
Inter-American Development Bank^e	No information.	Loans carry fixed or floating interest rates and are priced according to existing market conditions, reflecting the overall characteristics of the underlying project and client.	Partial credit guarantees carry fees or premiums that are market-based and depend on the risk covered and market benchmarks.	Existing market conditions are determined through pricing data made available through various databases (including their own transactions), soundings of commercial and institutional investors, and other pricing information available in the public domain.
International Finance Corporation^f	The International Finance Corporation (IFC) provides financing on commercial terms and conditions which it considers appropriate, taking into account the requirements of the enterprise, the risks being undertaken by the IFC and the terms and conditions normally obtained by private investors for similar financing.			The IFC charges market rates for its products and services, and has developed a rigorous methodology to price its loans and guarantees. The IFC's pricing reflects factors such as market conditions, as well as country and project risks.

^a <http://www.afdb.org/fileadmin/uploads/afdb/Documents/Financial-Information/Financial%20Products%20-%20Offered%20by%20the%20African%20Development%20Bank.pdf>.

^b In this document, the following definitions apply:

- Floating base rate: linked to a floating rate such as LIBOR;
- Fixed base rate: at the fixed-rate swap equivalent of floating-rate loans.

^c <http://www.adb.org/site/private-sector-financing/financial-products>.

^d <http://www.ebrd.com/downloads/research/factsheets/guidetofinancing.pdf>.

^e For the private sector only: <http://www.iadb.org/en/idb-finance/english/non-sovereign-financing,1985.html>.

^f The private sector arm of the World Bank Group:

http://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc/articles+of+agreement/about+ifc+-+ifc+articles+of+agreement+-+article+iii.

11. In the private sector, the financial terms of equity, debt or guarantees are based on a series of methodologies that include:

- (a) **Equity:** Equity valuation is based on a combination of selected valuation techniques including net present value of discounted cash flow, pricing of recent comparables, earnings multiples and/or price-to-book value;
- (b) **Loans:** Loans are priced based on risk-return metrics that include yield curves of comparable traded debt, expected loss norms and market comparables; and
- (c) **Guarantees:** Guarantees are priced similarly to debt less the price of liquidity.

III. Establishing concessionality

12. Current financing gaps severely hamper the implementation of mitigation and adaptation efforts of developing countries. Although current flows of debt and equity between developed and developing countries (estimated at US\$ 1.2 trillion per annum) are significantly larger than the additional climate financing needed (estimated at US\$ 450 billion per annum), they are not flowing to climate investments for a number of reasons:

- (a) Climate externalities are not internalized;
- (b) Investors are not able to take the additional risk that climate investments pose;
- (c) Market failure and absence of market delivery mechanisms remain key obstacles;
- (d) Appropriate financial instruments (maturity, price and level of subordination) do not exist; and
- (e) Projects are likely to be at sub-sovereign level.

13. Specifically for the private sector, there has been a lack of climate financing because of a risk-return imbalance that has resulted primarily from two of these main barriers:

- (a) High real or perceived levels of risk; and
- (b) Lack of local capital which translates into limited sources of finance and/or high costs of funds. This is particularly acute for sub-sovereign projects and private projects.

14. This chapter will outline how other relevant institutions provide concessional financing to address such barriers to investment in climate change activities.

3.1 Practices of other institutions

15. The current practice is for relevant institutions to price their own participation at market terms while providing concessional returns on the funding provided by climate funds.

3.1.1 Agence Française du Développement

16. Proparco, the private sector subsidiary of the Agence Française du Développement (AFD), does not provide concessional financing to the private sector (loans, guarantees or other structured instruments), but provides commercial-rate financing. Proparco can however complement commercial banks or investors through the provision of longer-term financing.

17. The AFD provides concessional (all levels including grant) and non-concessional funding (loans, lines of credits, guarantees and other structured instruments) to countries, local commercial banks, municipalities, utilities and non-governmental organizations, among other recipients, for development and climate change activities. In some cases the level of concessionality of the financing can be set up to include a climate premium for instance through

a reduced interest rate for climate-efficient activities in order to build the internal capacity of the recipient and send positive signals to the market.

18. The AFD has developed a carbon footprint methodology and calculator to measure the climate impact of its projects. However, this carbon footprint metric is not linked to the financial terms. The AFD prices using its track record, the level of income of the recipient country and the overall development and climate impact of the project/programme.

3.1.2 Climate funds

19. Concessional climate finance is often provided by climate funds such as the Global Environment Facility (GEF) and the Climate Investment Funds (CIFs) through their accredited entities (AEs). These AEs are often multilateral development banks (MDBs).

20. Given their AAA credit rating, MDBs do not provide their own financing at concessional terms, but provide their own commercial financing, which is priced at market terms based on risk.

21. MDBs channel funds from climate funds like the GEF and the CIFs at concessional terms, often blending these funds with their own resources. The terms and conditions of these concessional funds are determined on a case-by-case basis as outlined below in Table 2.

Table 2: Practices of the Climate Investment Funds and the Global Environment Facility

Providing concessionality	Practices
Structuring concessionality	The climate funds are structured and priced in collaboration with accredited entities, where the climate funds act as a participant investor.
Level of concessionality	When climate funds structure and price their concessional resources in collaboration with accredited entities they seek the optimal level of concessionality to avoid providing excess subsidy to the private sector or crowding out private sector investors. There is no mathematical methodology for determining the minimum level of concessionality, but instead it is based on qualitative assessment and rational justification. For instance, they can provide greater concessionality when there is a significant demonstration effect.
Mechanisms of concessionality	A number of mechanisms are used by climate funds to provide concessionality in partnership with accredited entities depending on the case. These mechanisms include reduced interest rates or return, longer maturity and greater subordination (higher rank in loss). The climate funds often aim to ensure risk-sharing arrangements and aligned interests with their accredited entities in the same investment tranche. However, a subordinated concessional tranche is sometimes used to overcome specific risks that cannot be absorbed solely by the accredited entity.
Efficiency	The climate funds encourage additional funding by their accredited entities and other third-party investors in order to maximize the efficiency of their resources. The Global Environment Facility also requires an assessment of cost-effectiveness as part of its proposal approval process.

IV. Application of the case-by-case provisions in the financial terms and conditions of the Fund's instruments

22. As stated in paragraph 54 of the Governing Instrument, the Fund will provide financing in the form of grants and concessional lending, and through other modalities, instruments or facilities as may be approved by the Board. Financing will be tailored to cover the identifiable

additional costs of the investment necessary to make the project viable. The Fund will seek to catalyse additional public and private finance through its activities at the national and international levels.

23. At its fifth meeting, the Board of the Green Climate Fund adopted a set of guiding principles and factors for determining terms of financial instruments, as outlined in decision B.05/07.⁶ These guiding principles and factors constitute the foundation of the terms and conditions of the Fund's instruments.

24. As requested by decision B.09/04, the Fund and its accredited entities will take these guiding principles and factors into account when providing finance to climate change projects and programmes. Furthermore, the Fund and its accredited entities will take into consideration the Fund's investment guidelines as contained in decision B.07/06.⁷

25. This chapter outlines the application of the case-by-case provisions in the financial terms and conditions of the Fund's instruments.

4.1 Level and structuring of concessionality

26. As stated in decision B.05/07,⁸ the Fund will structure terms on a case-by-case basis to address specific barriers, where the grant element of concessional finance is tailored to provide the appropriate incentive to facilitate the implementation of mitigation and adaptation activities. The Fund will seek the right level of concessionality, so as not to displace investments that would otherwise have occurred, including for private sector investment.

27. It will likely be very difficult to determine a formulaic methodology for determining the terms and conditions of concessional funding, due to a variety of factors including information asymmetry, nascent markets and the lack of an existing portfolio.

28. While in theory, the Fund could base its terms and conditions on the impacts of its investments, this might lead to market distortions. This may contradict the guiding factor outlined in decision B.05/07⁹ that states that concessional forms of finance will be designed to minimize market distortions and potential disincentives to private investment, as well as the principles of avoiding crowding out commercial financing and covering identifiable additional costs necessary to make the project viable. A model that has successfully been implemented at global scale to undertake this approach does not appear to exist. The Fund will take into account the Fund's investment guidelines as contained in decision B.07/06¹⁰ when providing concessionality on a case-by-case basis, rather than relying on a model.

29. In accordance with decision B.05/07,¹¹ the Fund will take into account the expertise and capacity of accredited entities. The Fund relies on these entities for channelling resources to projects and programmes that are market-, sector- and country-specific.

30. The Fund could therefore base its financial terms and conditions on the recommendations of and dialogue with the accredited entity through which it is investing, as they have intimate knowledge of local market conditions that would not be publicly available. As such, the Fund will partner with them for structuring and providing justification for its financing. This will enable the Fund to benefit from the risk/return models, the extensive local market knowledge and the track record of its accredited entities. Accredited entities will follow

⁶ Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013*.

⁷ Chapter III in Annex XIV of the document GCF/B.07/12 *Report of the Seventh Meeting of the Board, 18-21 May 2014*.

⁸ Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013*.

⁹ Annex III to of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013*.

¹⁰ Chapter III in Annex XIV of the document GCF/B.07/12 *Report of the Seventh Meeting of the Board, 18-21 May 2014*.

¹¹ Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013*.

the guiding principles and factors for determining terms of financial instruments as outlined in decision B.05/07.¹²

31. Depending on the terms of financing, the Fund may also be able to share risk with its accredited entities, a factor which the Fund will take into consideration when determining the terms of its instruments, as stated in decision B.05/07.¹³ The risk of the investment will be assessed using due diligence produced by the accredited entities.

32. The Fund will also take into consideration the average concessionality or grant element of the financial inputs to the Fund and the average concessionality or grant element of financial instruments of the Fund, and will promote long-term financial sustainability as stated in decision B.05/07.¹⁴ This will be guided by the methodology and determination of the Fund's initial risk appetite, which is currently under development.

4.2 Mechanisms to provide concessionality

33. The Fund's accredited entities could employ one or a combination of the following mechanisms outlined in Table 3 to provide concessionality for projects and programmes using the Fund's resources.

Table 3: Examples of mechanisms to provide concessionality (when justified)

Instrument	Grants ^a	Equity	Senior debt	Subordinate debt	Guarantees
Mechanisms	<ul style="list-style-type: none"> - Always concessional - Reimbursable grants are repaid if a project is successful and performance hurdles of other investors have been met. 	<ul style="list-style-type: none"> - Lower return-on-investment than other investors - Higher risk-bearing tranche - Last to exit (patient capital) 	<ul style="list-style-type: none"> - Lower interest rate - Longer tenor - Last to exit 	<ul style="list-style-type: none"> - Junior rank on security - Junior in cash waterfall - Covenants less stringent (e.g. debt service coverage ratio) - Longer tenor/last to exit 	<ul style="list-style-type: none"> - Sub-market guarantee fees - Greater risk cover than available on the market

^a Note that there will be a reimbursement obligation in cases of prohibited practices.

4.3 Efficiency

34. In accordance with decision B.05/07¹⁵ the Fund will leverage other financing, including public and private financing, seeking to maximize leverage in the case of private financing. This will enable the Fund to maximize the efficiency of its resources, and will be determined on a portfolio basis.

V. Conclusion

35. The Fund will partner with its accredited entities to structure its financing and determine the appropriate level of concessionality, using a number of mechanisms that are

¹² Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013.*

¹³ Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013.*

¹⁴ Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013.*

¹⁵ Annex III of the document GCF/B.05/23 *Decisions of the Board – Fifth Meeting of the Board, 8-10 October 2013.*

instrument-dependent. Finally, the Fund will also aim to maximize the efficiency of its resources.

36. In doing so, the Fund will be able to provide the right level of concessionality to climate change projects and programmes that would otherwise not have taken place, and will be able to fulfil its mandate of promoting the paradigm shift towards low-emission and climate-resilient development pathways.
